Personnel

OLL 83-2650
9 November 1983

MEMORANDUM FOR THE RECORD

SUBJECT: House Hearing on Entitlements

1. The Entitlements, Uncontrollables and Indexing Task Force of the House Budget Committee held a 9 November 1983 hearing on entitlements. Of principal interest was the testimony provided by Mr. John Erlenborn (R., IL) on his FAIR (Federal Annuity and Investment Reform) legislation--H.R. 3751, H.R. 3752 and H.R. 3753 introduced this session.

2. Congressman Erlenborn was the first witness before the Task Force. His testimony is attached for your review. It was presented nearly verbatim. Also attached are less relevant but nonetheless interesting testimony relating to the burgeoning federal deficit and the drastic need for a solution. The final attachment is a hurried summary of questions and answers posed to and provided by Representative Erlenborn.

3. The Erlenborn statement is important because of the insight it provides into the supplemental retirement legislation he has recently introduced (H.R.'s 3751-3753) more to follow.

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Attachments
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A FAIR WAY TO CONTROL FEDERAL RETIREMENT PROGRAMS

Statement by

U. S. Representative John N. Erlenborn (R-IL)

before the

U.S. House of Representatives Budget Committee

Task Force on Entitlements Uncontrollables, and Indexing

Wednesday, November 9, 1983

Mr. Chairman, if Congress is serious about holding the line on burgeoning Federal deficits, we must bring entitlement programs under control. Your Task Force can be a most constructive force in that endeavor. I applaud your work, and I thank you for inviting me to explain how my FAIR program -- FAIR stands for Federal Annuity and Investment Reform -- will help to curb the uncontrolled cost in the various Federal retirement-related entitlement and pension programs in -- if you'll pardon the pun -- a FAIR way.

As we all know, entitlements are payments that go to anyone who is eligible for a Federal benefit. Their costs have a way of increasing, whether by cost-of-living adjustments (that is, COLAs) or added numbers of participants. The Federal retirement system consists of a patchwork of inequitable entitlements which have gotten out of hand.

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Payments made to civil service and military retirees in 1982 amounted to $42.6 Billion, and employees contributed only about 14 per cent of the civil service retirement system's revenue. The drain on the Federal treasury will get even worse next January, when new Federal workers and re-hires will be drawn into the Social Security System. Tax dollars will then be matching the Social Security old-age and survivors tax they will pay in addition to the seven per cent of salaries paid into the civil service pension fund.

Reports dealing with Federal pension problems have been issued by several Presidential Commissions, the Congressional Research Service, the Universal Social Security Coverage Study Group, the General Accounting Office, and private research organizations. My FAIR proposal benefits from the recommendations of these reports and my experience with private pension matters by virtue of my private law practice and my 27 years as a legislator, with 17 of those years as a member of the House Committee on Education and Labor.

Three separate bills are involved.

H.R. 3751 - COLA Equity

The first bill, the COLA equity bill is H.R. 3751. It addresses one of the often heard criticisms that Federal pensions cost so much because they have two features unmatched in the private sector -- retirement at age 55 and full inflation protection. H.R. 3751 would bring about greater equity by limiting post-1983 COLAs to 60 per cent of the COLA increase for those benefits exceeding the level of the maximum retirement benefits payable to a new retiree under Social Security -- which will be about $10,000 in 1984 -- when an employee's benefits under all Federally sponsored retirement and disability systems are combined.

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The fact that retirees under present law can draw combined military and civilian retirement income of $25,000, $35,000, $45,000, $55,000 (even in rare cases over $60,000) and still receive full COLAs equal to 100 per cent of the consumer price index (CPI) is as much an affront to just plain good sense as it is to the already overburdened Federal taxpayer. The uncapped COLA has created an embarrassment of riches to the minority of Federal retirees who have become well-heeled as a result of the present inequity.

It is clear that the current structure is in need of change when retirees can ultimately draw more in retirement than their on-the-job replacements will earn while working. The present COLA formulation leading to this result has also dramatically increased the spread in the dollar amount of pensions which employees retiring at different pay levels initially receive. This built-in "rich get richer" principle can be illustrated (when considering past double-digit rates of inflation) by comparing 1) the $100 per month increase accruing to the typical retiree with 2) the $6,000 <u>per year increase</u> going to the fortunate few drawing $60,000 Federal pensions.

If the provisions of H.R. 3751 had been in effect in the past, the spread between high income and moderate income retirees would have been kept more in check and the retirement income of Federal employees retiring with long-service and above average wages would not have spurted ahead of the earned income of their counter-

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parts in the active workforce. The provisions of the bill are prospective in application, would reduce no retiree's pension, but would serve to moderate future benefit increases for those persons retiring at above average wage levels.

The provisions of H.R. 3751 would also bring the COLAs under the current Federal systems more in line with leading private pension fund practices. This is only fair inasmuch as the average cost-of-living wage increase agreed upon in private sector collective bargaining has averaged about 60 per cent of the increase in the CPI.

Interestingly, many of the private and State and local government retirement systems which have automatic post-retirement COLAs cap the COLA at 3 per cent -- 60 per cent is the percentage benefits would increase under those plans if a long-term inflation rate of 5 per cent were assumed.

The 60 per cent COLA provision would also aid greatly in controlling the rapidly escalating unfunded liabilities among the various Federal pension systems. As a result of legislation which I authored (P.L. 95-595) a more realistic actuarial assessment of all Federal financial reports required of all Federal plans show that their combined unfunded liabilities (exclusive of Social Security) exceeds $1 Trillion, a debt which will have to be paid but which is in addition to the already recorded Trillion-dollar-plus national debt. Over $100 Billion of this pension debt has been created in just the past few years under the Civil Service Retirement System alone.

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Additionally, introducing the 60 per cent COLA escalator factor will help restore the public support that is required if the taxes necessary to fund future benefits are to be supplied in sufficient quantity to meet full expectations and help restore a new measure of financial health to the major Federal civilian and military retirement systems.

H.R. 3752 - the Federal Annuity and Investment Reform Act

The second bill in the FAIR package is H.R. 3752, the Federal Annuity and Investment Reform Act.

In brief, the FAIR program (1) establishes a defined benefit and thrift plan arrangement comparable to that found in the private sector to provide supplementary benefits for those Federal employees newly covered under Social Security, (2) conforms the provisions of the present Civil Service Retirement and Disability System to minimize future differences in contributions and benefits for present employees as compared with those newly covered under Social Security, (3) strengthens the financing of the Civil Service Retirement and Disability System by maintaining the one system for both old and new employees, by requiring full dynamic normal costs to be contributed on behalf of both old and new employees, by requiring full employer contributions to amortize the initial unfunded liablity over 40 years as a level percentage of payroll, and by providing the opportunity for enhanced investment earnings of the system, (4) extends the accrued benefit protection applicable to qualified private plans to the benefits under the Civil Service Retirement System (CSRS), and conforms the provisions of the CSRS and the new Federal Thrift Plan to the standards required under ERISA (The Employee Retirement Income Security Act of 1974), and (5) provides for the

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voluntary election by current Federal workers to be covered under Social Security and the provisions of the CSRS and Federal Thrift Plan applicable to new employees.

As a result of FAIR, an additional, direct benefit will accrue to the financial health of the Social Security Old Age, Survivors, and Disability Trust Funds. Since current employees may make an irrevocable election to come under both Social Security and the provisions of the CSRS and Federal Thrift Plan applicable to new employees, an additional employee and employer contribution of 5.7 per cent of pay for each employee making the election will be made to the Social Security trust funds beginning in 1984.

Enactment of FAIR would also make many Billions of dollars available to repay loans made by the Medicare trust fund to the old-age, survivors, and disability funds and allow additional interfund borrowing if necessary.

<u>H.R. 3753 - COLA Stabilizer</u>

I call the third bill in the FAIR package (H.R. 3753), the COLA stabilizer.

The Congressional Budget Office reports that nearly one-third of total Federal spending is accounted for under indexed entitlement programs. Over the past four years alone, the COLAs under these progams have increased program spending by 50 per cent. Retirement and disability programs account for over 99 per cent of all COLA-related entitlement program spending.

To help assure long-term program solvency and to regain a measure of fiscal control, the COLA stabilizer would limit automatic increases after 1983 to the lesser of the increase in national wages or the increase used in the CPI. The stabilizer would apply to all pension, annuity, retirement, disability and similar programs operated by the Federal government, including, but not limited to, the

Civil Service Retirement System, the Uniformed Service Retirement System, the Railroad Retirement System, and the Social Security System; but programs basing benefits on need would be exempted.

Working Americans in and out of government are willing to accept some adjustments in future COLAs as long as no one group suffers for the gain of another. No one wants to be singled out unfairly. The COLA stabilizer is fair to all.

No longer would people on government pensions get bigger COLAs than working Americans. The stabilizer would end this inequity between working and non-working generations.

Importantly also, the stabilizer would not reduce benefits, but would merely put a reasonable limit on future post-retirement benefit increases.

In today's dollars, even a one per cent difference in COLAs would give us a $2 Billion easing of the strain on all Federal old-age, disability, and retirement programs.

<u>Conclusion</u>

The FAIR package is a sweeping reform of Federal pension programs. It is long-term. It is comprehensive and, therefore, necessarily complex. The provisions, however, have been worked out in great detail. I have asked the Office of Management and Budget, and the Office of Personnel Management, for their anal- ysis of the savings that would result from FAIR.

Thank you again for allowing me to present a few of the details to you today. I am dedicated to passage of my FAIR package before I retire from Congress at the close of this term. Enactment would reduce retirement benefits for which I will be eligible, but more importantly bring fairness and cost controls to Federal pension and disability entitlement programs.

I hope your Task Force will be able to get behind FAIR, and

The Federal Budget: Outlook, Importance, and Alternatives*

by James Capra
Senior Economist, Lehman Brothers Kuhn Loeb

Despite the cyclical economic rebound the economy is now experiencing, the outlook for the federal budget remains a serious problem. It is a threat to continued noninflationary growth.

This morning, I want to briefly bring a few facts to your attention.

- First, with the Congress being in and out of recess for the last few months and decision-making on the budget grinding to a halt, it is useful to re-examine the numbers to see if anything has changed -- especially since economic statistics that have been released recently have been so good.

- Secondly, there are those who suggest that the economy will grow out of the deficits or that deficits are unimportant, regardless. These points need to be examined critically. Maybe, they are true, in which case the budget conservatives are simply "crying wolf."

- Once these questions are disposed of, I would like to look at what needs to be done to start to bring the budget under control. In that regard H.R. 3790 is a possible first step. But, what of the objections that it is unfair to go back to social security for budget cuts after the recent legislation or that social security is a separate system that should be considered apart from the budget.

- Finally, I would like to do something unusual and outline what kind of fiscal imbalance we might be bequeathing to our children and grandchildren early in the next century if the deficit problems are not alleviated soon.

The Outlook -- An Update

Using the latest technical estimates and reestimates and a robust economic growth scenario -- about 5.0 percent real growth in 1984, and 3.5 percent growth (on average) in 1985-1988, we find that the outlook for the deficit has changed little.

* Testimony Before the Task Force on Entitlements, House Committee on the Budget, November 9, 1983.

Deficits of about $200 billion in 1984-1986 and $250 billion in 1987-1988 are what is in store in the absence of a major policy shift. (See Table 1). To those who would argue that the country can grow out of the deficits, Table 2 responds with figures showing that with 6 percent real economic growth over the next few years, the deficit would still be $160 billion by 1986 and we would only start to inflate our way out by 1988. In all likelihood, however, in contrast to these optimistic scenarios, the economy will experience a recession sometime within the next five years. In that case the deficits will become larger than shown here -- about $300 billion by the end of the period.

Table 1. Federal Deficit Projections — Baseline Estimate*

— In Billions of Dollars —

FY1983	FY1984	FY1985	FY1986	FY1987	FY1988
$197.4	$196.2	$199.4	$218.0	$243.0	$244.5
— As a Percentage of GNP —					
6.1%	5.6%	5.3%	5.2%	5.3%	5.0%

*Assumes real GNP growth of 5.4%, 3.6%, 3.2%, 3.4%, and 3.4% in fiscal years 1984-1988, no change in tax and nondefense spending policies, and a 5 percent real growth in defense budget authority in each year.

Table 2. Deficits Under Alternative Economic Scenarios

	Baseline Growth Scenario			Record Growth Scenario (1962-1966 Growth)			Slightly Slower Growth Scenario (1976-1980 Growth)		
	Real GNP Growth	Inflation (GNP Deflator)	Deficit	Real GNP Growth	Inflation (GNP Deflator)	Deficit*	Real GNP Growth	Inflation (GNP Deflator)	Deficit*
1984	5.4%	4.2%	$ 196b	6.0%	4.5%	$ 191b	4.5%	4.0%	$ 204b
1985	3.6	4.5	199	6.0	5.2	171	3.4	4.2	209
1986	3.2	5.2	218	5.5	6.1	160	3.4	4.9	229
1987	3.4	5.3	243	5.0	7.2	148	3.4	5.0	257
1988	3.4	5.4	245	4.6	8.3	102	3.4	5.0	264
Cumulative 5 year real growth**	20.5%			24.0%			19.5%		
Average Annual Rate of Growth	3.8%			4.4%			3.6%		

*Deficits were computed by adjusting baseline estimates of revenues for the difference in nominal incomes relative to the baseline scenario and by adjusting outlay estimates for unemployment compensation, food stamps, and other means tested programs for the difference in the projected unemployment rate relative to the baseline. Finally, estimates for interest on the debt were adjusted, relative to the baseline, to reflect both the effects of higher (or lower) nominal interest rates because of changes in the inflation rate and the effect of changes in the volume of government financing.

**No 5-year period in the 1970's had cumulative real growth as high as 20%.

Are Federal Deficits Important?

Some public officials have recently been repeating a point made by academicians in the 1970's -- namely, historically, deficits were not high at the same time interest rates were high, and so, even if the economy does not grow out of the projected deficits, they do not pose a threat.

First, it is important to point out that the deficits we face are without precedent in the postwar period, both in magnitude and duration. As shown in Table 3, for example, the deficit and its drain on the credit markets peaked in calendar year 1975 and quickly subsided. That is not the case now, as shown in the accompanying Table 4. In 1977, in the third year of the recovery, public sector borrowing absorbed only 20 percent of funds raised in the credit and equity markets. In 1985, at what would be a comparable stage of the business cycle, public borrowing is projected to absorb 40 to 55 percent of the funds raised.

Table 3.

Funds Raised in the Credit and Equity Markets

Calendar Year	Total Funds Raised	Public Sector Borrowing*	Public Sector Percentage	Private Sector Percentage
1973	$201.7b	$ 21.5b	10.6%	89.4%
1974	193.9	27.3b	14.1	85.9
1975 (1st Recovery year)	214.4	99.1	46.2	53.8
1976 (2nd Recovery year)	273.5	84.2	30.8	69.2
1977 (3rd Recovery year)	334.3	72.2	21.6	78.4
1978	401.7	72.8	18.1	81.9
1979	402.0	57.6	14.3	85.7
1980	397.1	106.3	26.8	73.2
1981	406.9	109.7	27.0	73.0
1982	440.7	207.1	47.0	53.0

*Includes federal and state-local borrowing.

Table 4. Funds Raised in the Credit Markets — Alternative Scenarios

Calendar Year	Total Funds Raised*		Public Sector Borrowing		Public Percentage		Private Percentage	
	8% Scenario	11% Scenario	Federal	State-Local	8% Scenario	11% Scenario	8% Scenario	11% Scenario
1983 (est.)	$ 503b		$ 214b	$ 45b	51.5%		48.5%	
1975 First Recovery Year					46.2		53.8	
1984	450	606	215	43	57.3	42.6	42.7	57.4
1976 Second Recovery Year					30.8		69.2	
1985	476	662	218	46	55.5	39.9	45.5	60.1
1977 Third Recovery Year					21.6		78.4	

*Includes domestic nonfinancial borrowing, nonfinancial borrowing by foreigners, domestic and foreign equities issued in the United States.

A second reason why it is likely that deficits now projected will affect interest rates (and may be affecting them now) is that we are now operating under a different monetary policy regime. There is no indication that this Federal Reserve Board Chairman or other members of the Federal Open Market Committee are going to accommodate these deficits. My colleague Allen Sinai has put these two facts together -- the expected size and persistence of large deficits and the post-October, 1979 monetary policy regime -- into an analytical relationship that suggests that long term corporate bond rates are 200 to 300 basis points higher than they would be if the expectation were for $100 billion rather than $200 billion deficits.

Where will all the funds needed to finance the deficits come from and what will be the effects? The answer is, from our savings and the savings of the rest of the world. Table 5 is extremely important, demonstrating a couple of critical facts.

Table 5. **Saving Available for Investment**
(By calendar year, as a percent of GNP)

	1961 to 1970	1971 to 1980	1985 Projection
Private Savings	4.7%	4.9%	4.0%
Business savings (gross)	11.7	12.0	13.5
Subtotal gross private saving	**16.4**	**16.9**	**17.5**
State-local budget surplus	-	+1.0	+1.0
Net foreign investment (net flows of capital)	-0.5	-0.1	+1.6
Subtotal amount available to finance the federal deficit and for investment	**15.9**	**17.8**	**20.1**
Federal deficit	-0.5	-1.9	-5.3
Subtotal, amount available for gross private investment	**15.4**	**15.9**	**14.8**
Capital consumption allowance	-8.4	-9.9	-11.0
Total amount available for net new investment	**7.0**	**6.0**	**3.8**

First, even with larger domestic private savings (as a share of GNP) and large foreign capital inflows, the 1985 deficit would still siphon off enough saving to reduce the funds available for private investment as a share of GNP to well below the 1960's and 1970's averages. Also, those foreign capital inflows, "net foreign investment" in the table, are the financial counterpart of massive current account deficits, which have literally cost millions of jobs in export and import competitive manufacturing sectors. This year the merchandise trade deficit is likely to be $60 billion and we forecast that it could grow to $90-$100 billion in 1984. The deficit on manufactured goods, where the Institute for International Economics estimates there are 25,000 to 40,000 jobs per billion dollars of exports, will grow by $25 billion in 1983 and probably by another $25 billion in 1984. Lasting damage is being inflicted on our international trade competitiveness that may be hard to repair. In short, foreign capital inflows are helping to reduce somewhat the financial crowding out of private borrowing. (That is the significance of the +1.6 percent of GNP that is made available for financing the federal deficit and for investment in the last column of the table.) But, this reduction in financial crowding out is taking place through a process that crowds U.S. exporters and domestic competitors to foreign imports out of the markets for manufactured goods. It is their products, their profits, and ultimately their workers that will be crowded out by large federal deficits. An important byproduct of this is increasing discussion of protectionist legislation, an outcome in which no one comes out a winner.

I find that when looking at the budget problem and trying to evaluate goals, it is useful to use Table 5. It's clear from that table that cutting the deficit to 2 percent of GNP would markedly improve things. Funds available for investment would rise, provided that the budget cuts were not directed at cutting personal and business saving. In that light, the table makes it clear that budget restraint that would reduce the flow of saving would not be a helpful step. Although such actions may have to be part of a package of changes for political reasons, it is clear that they do not contribute to a long run goal of improving capital formation and easing credit market pressures.

What Will It Take to Reduce The Deficit Significantly?

The deficit is a little like the weather. Everyone talks about it, but no one does anything about it. That may be because the choices are very difficult ones.

To reduce the deficit to 2 percent of GNP by, say, 1986 would require $135 billion of budget changes, according to our calculations -- $100 billion of combined spending cuts and revenue increases and we estimate about a $35 billion reduction in interest costs.

On the revenue side $50 billion in tax increases is about what the First Concurrent Budget Resolution had in mind. The tax part of HR. 3790 could be a part of the total but would not raise nearly enough. It would take some major new tax -- like some form of consumption tax -- together with miscellaneous other changes like those currently being considered by the tax committees to reach this goal. On the tax side, embedded within what I believe to be an extreme position taken by supply-siders -- such as Norman Ture in his Wall Street Journal article -- is an important point. Tax increases that reduce saving are not very useful.

It is clear that something can be done on the revenue side. Outlays are another matter. And here I am primarily referring to nondefense outlays. Congress has already set out on a course that is scaling back the President's defense buildup. The baseline projections that were shown in Table 1 assume a cut of $18 billion in outlays from the President's proposals for 1985 and a bigger cut for 1986. This is what was assumed in the First Concurrent Resolution and action to date by the authorization and appropriation committees is consistent with those cuts.

With respect to nondefense outlays, the view exists that with the Social Security (OASDI) legislation of this year, further changes -- such as COLA freezes -- are not legitimate options. As shown in Table 6, this results in an untenable position from which to try to get $50 billion in spending cuts. When interest, defense and OASDI are excluded from projected 1986 outlays, all that is left is $387 billion. Many of the programs that are left, shown in Table 7, are ones that have already been cut. It is unreasonable to expect that $50 billion would be taken from these programs -- reducing them in 1986 to $10 billion below the estimated level for 1984. I believe we are left with the inescapable conclusion that if a big cut -- like $50 billion -- is to be made in spending, social security and maybe even defense will have to suffer some further cuts.

Table 6. **What Is Left When Interest, Defense, and OASDI are Excluded?**

Projected 1986 Total Outlays	**$ 1010.4 b**
less: Interest	143.4
Defense	276.9
Social Security (OASDI)	203.0
Projected Remainder, nondefense, noninterest, non-OASDI	**$ 387.1 b (9.3% of GNP)**

Table 7. **Composition of Nondefense, Noninterest, Non-OASDI Spending for 1986**

Medicare	$85.5 b	
Civil Service/Military Retirement	45.0	$187.8 b — Limited reductions in these programs.
Other nonmeans tested benefits	57.3	
Means tested benefits	85.3	
Grants to state-local governments	57.4	$199.3 b — Where most of reductions in growth of spending have taken place.
Civilian agency pay	39.0	
Other Operations and Subsidies (agricultural price supports, business subsidies, etc.)	17.6	
Total. Nondefense. noninterest. non-OASDI	$387.1 b	

Social Security and H.R. 3790

The proposal by Chairman Jones and others, H.R. 3790, would index social security and other nonmeans tested benefit programs to the CPI minus 2 percentage points in 1985-1990. One argument made against this proposal and other proposals, such as the call for a two year freeze on COLAs, is that future benefits for current social security recipients were already cut in the recently passed legislation and so it is not appropriate to return to them for further reductions. Another argument is that social security is a separate system and should be considered outside the budget. In fact, after 1990, the new law orders that it be taken "off-budget."

There are some important counterarguments that should be brought up. First, most of the recipients who would be affected by H.R. 3790 received COLA adjustments well in excess of what is generally accepted as having been the rate of inflation at the time, because of distortions in the CPI. In 1978 to 1981, COLAs increased benefits by 59.8 percent while consumer prices, as measured by the personal consumption deflator, rose by 47.7 percent, when meansured on the first quarter to first quarter basis used for indexing social security. This "overindexing" gap of 12 percentage points is almost exactly what would be lost between 1985 and 1990 under the "CPI minus 2" formula in H.R. 3790.

Second, a careful examination of some of the effects of the new law make it clear why it may be appropriate to cut back COLA's for current beneficiaries and why it will soon not be possible to suggest that social security be viewed as a separate system, outside the budget.

The long term social security problem, prior to the recent amendments, is depicted in Figure 1, which shows that on a present value basis, expected lifetime benefits were scheduled to exceed lifetime employer-employee tax payments for all cohorts of workers, forever. In other words, the fact that the average worker could expect to get more out of the system than he and his employer had contributed was not just a temporary, transitional phenomenon that would disappear once the system had matured. Rather, a subsidy was built into the system. This just could not continue if the system was to remain self-financed.*

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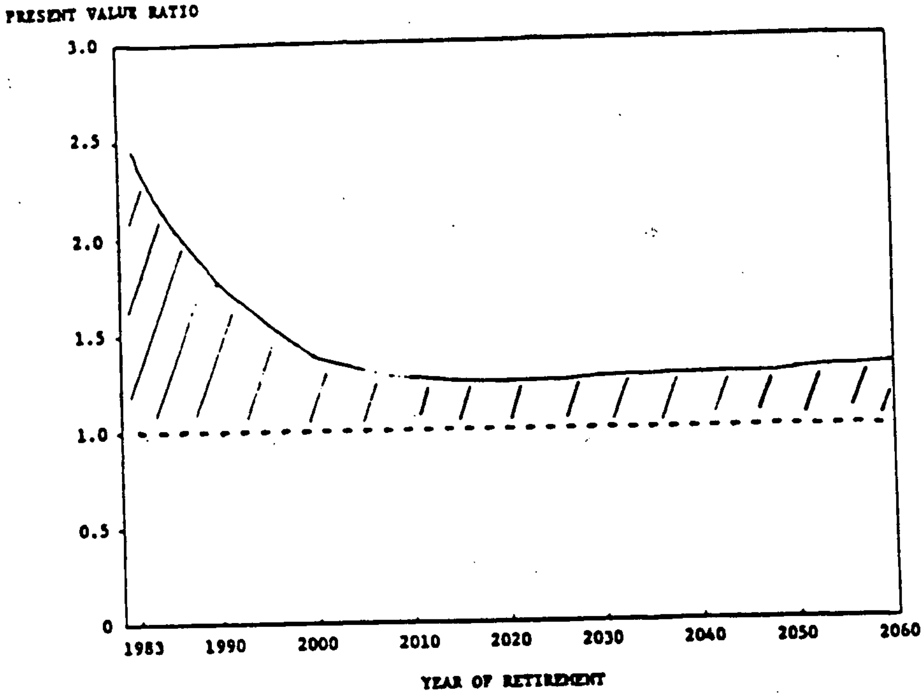
* Some theoretical research had at one time suggested that such a Ponzi scheme in a pay-as-you-go social insurance program could continue forever, but that work was based on the assumptions of steady rates of population and productivity growth. The real world, where there are wide year to year fluctuations in the rates of population and productivity growth, is simply not consistent with those theoretical models, making them at best useless and at worst misleading for policymakers.

Figure 1
Present Value Ratios Prior to the 1983 Amendments[1]



1 Figures were estimated under the intermediate scenario in the Social Security Administration's 1983 Trustees Report for a retiree with average lifetime earnings who is single or has a working spouse who qualifies for benefits independently.

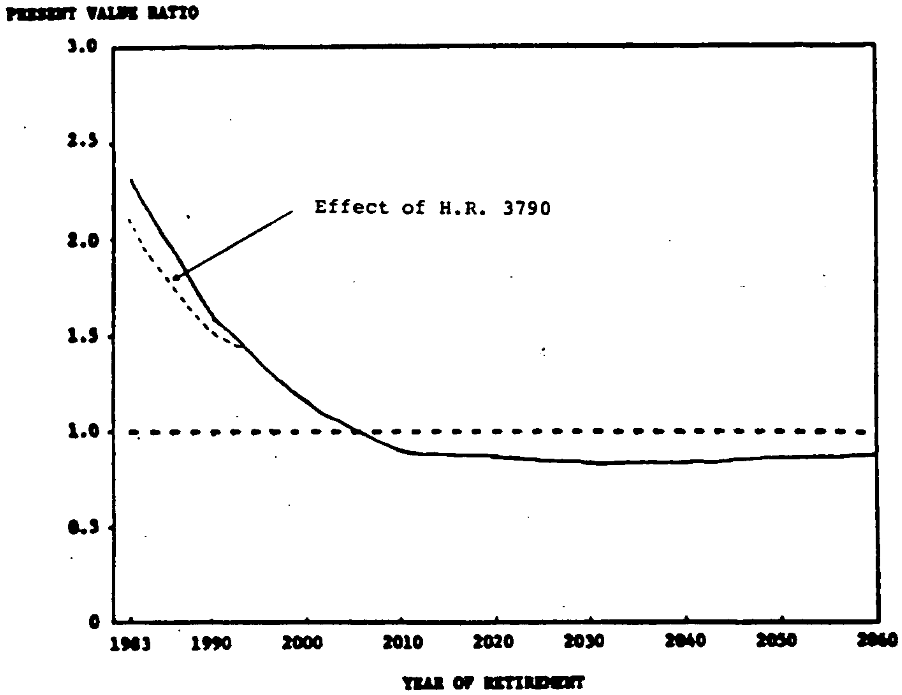
The changes made by the new legislation are shown in Table 8. We estimate that some small reduction was made in the returns on employer-employee taxes for a 1983 retiree, but the largest changes were made in the returns for retirees after 2010 -- individuals who entered the workforce after 1965 and will enter the workforce in the future. Starting with 2006 retirees, an average wage earner can expect to receive a present value of benefits that will be less than the present value of taxes. The new plot of the ratio of the present value of benefits over the present value of taxes is shown in Figure 2. In the next figure, the same type of plot is made, by pre-retirement income group. A maximum wage earner will have a very low ratio -- about 0.6.

Table 8
Estimated Savings to OASDI Operations From the 1983 Amendments Under the Intermediate and Pessimistic Scenarios
(Calendar year, billions of dollars)

	1983	1984	1985	1986	1987	1988	1989	Total, 1983-1989
Tax benefits	--	2.6	3.2	3.9	4.2	5.6	6.7	26.6
Move up scheduled tax increases	--.	8.6	0.3	--	--	14.5	16.0	39.4
Increase tax on self-employed	--	1.1	3.1	3.0	3.2	3.7	4.4	18.5
Military wage credits	18.4	-.4	-.4	-.3	-.4	-.4	-.4	16.1
COLA delays	3.2	5.2	5.4	5.5	6.2	6.7	7.3	39.4
Expand coverage	--	1.5	2.2	3.0	3.9	5.0	6.1	21.8
Raise retirement age	--	--	--	--	--	--	--	--
COLA stabilizer	--	--	--	--	--	--	--	--
Other	1.2	0.6	0.1	0.2	0.4	0.7	1.1	4.3
Total for all changes	22.8	19.2	13.9	15.3	18.0	35.8	41.2	166.2
Deficits prior to Amendments	23.0	20.0	12.0	14.0	15.0	16.0	17.0	117.0

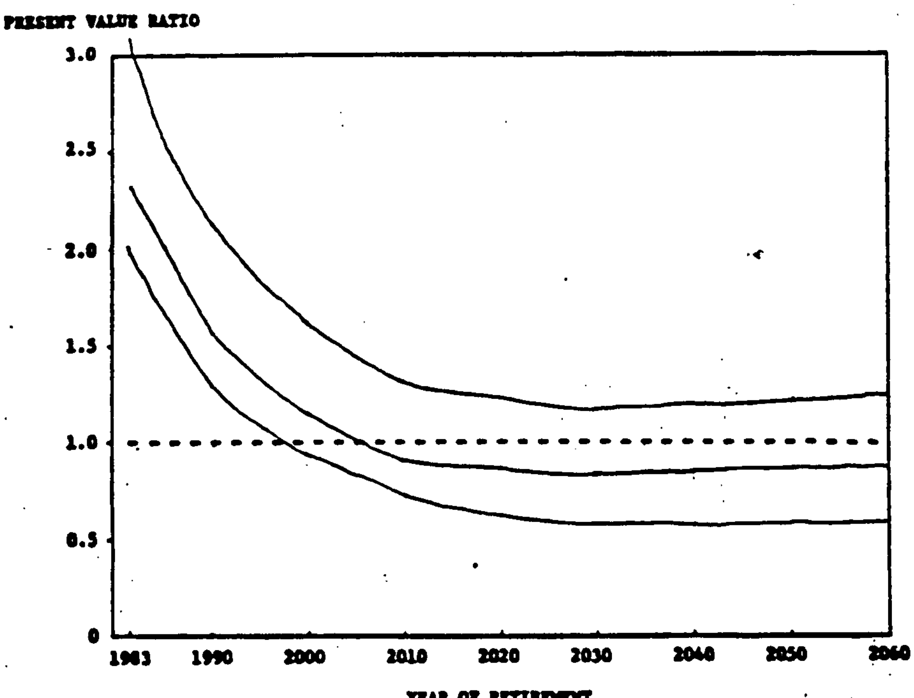
1 Figures are based on the 1983 Trustees Report. Figures in parentheses are estimated from the pessimistic scenario. Components may not sum to totals due tor ounding. Since the figures are based solely on OASDI operations, they do not include the $12.4 billion owed by OASDI to HI.

Figure 2
Present Value Ratios After the 1983 Amendments[1]



[1] Figures were estimated under the intermediate scenario in the Social Security Administration's 1983 Trustees Report for a retiree with average lifetime earnings who is single or has a working spouse who qualifies for benefits independently.

Figure 3
Present Value Ratios After the 1983 Amendments By Pre-retirement Income Groups[1]



[1] Figures were estimated under the intermediate scenario in the Social Security Administration's 1983 Trustees Report for retirees who had earned the minimum, average and maximum wage (as defined by the Social Security Administration) and who is single or has a working spouse who qualifies for benefits

The charts convey two messages. First, current beneficiaries are still receiving returns on benefits that are well in excess of the value of their lifetime employee-employer contributions. It is difficult to make the argument that reducing these subsidies a bit is unfair. As shown in Figure 2, H.R. 3790 would lower the subsidy and flatten out the curve somewhat, but the subsidies to current beneficiaries would still be there and would still be substantial.

A second message of the charts is that it is unlikely that social security, as a self-financed and isolated social insurance system, will be able to survive, for the following reason. Public support for the system is likely to erode as people realize the poor return they will be getting on their contributions. (Surveys show that even though social security has been paying enormous subsidies since its inception, many people are still under the impressing that they don't get their "money's worth.") One can only speculate what the surveys will show when people in fact do not get their "money's worth." Thus, even though the new legislation technically takes social security "off budget" in 1990, it is clear that at some point, the system will be lumped together with other government expenditures, and decisions on social security will have to be made within the context of decisions about the level and composition of all government spending. It will not be possible to act as if social security is a program apart from the rest of the budget.

The Consequences of Delay -- Long Term Projections

The political difficulty of undertaking the types of changes that would be required in order to substantially cut the deficit leads quite naturally to the question of what happens if nothing is done.

This is not the time to discuss what happens to the economy if nothing is done. So many short and long term factors are involved that it would take more time than is available to discuss them thoroughly. What we have done for today, though, is take a futuristic look at the budget to see if the problem ever goes away or simply gets worse. The analysis is preliminary and will be elaborated upon in the future. But, even these early results are quite revealing.

A projection of the budget in 2000 and 2025 was done under the Social Security Administration's II-B and III economic and demographic scenarios. These scenarios were chosen not necessarily because they are the most likely -- although if we had to choose between them we would select Scenario III, shown in Table 9. The advantage of using these scenarios is that they are well known and ready-made estimates for three big programs -- OASDI, Hospital Insurance, and Supplementary Medical Insurance -- are available.

For the two scenarios, we assumed no change in tax laws, current services for nondefense spending and two possibilities for defense:

-- real growth equivalent to the economy's real growth rate, so that the GNP share for defense (excluding retired pay) remains at 6.7 percent forever.

-- or a continuation of 5 percent real growth through the year 2000, until the GNP share for defense reaches about 9 percent, and then a constant GNP share thereafter.

Table 9

Long Range Economic Assumptions Used in Social Security Trustees' Scenarios* — IIB ("Intermediate Pessimistic") and III ("Pessimistic")

	Real GNP Growth		Inflation Rate		Unemployment Rate	
Year	IIB	III	IIB	III	IIB	III
1990	3.0%	2.7%	4.0%	5.0%	6.5%	7.4%
1991	3.0	2.6	4.0	5.0	6.2	7.0
1992	3.0	2.5	4.0	5.0	5.8	6.8
1993	2.5	2.3	4.0	5.0	5.7	6.6
1994	2.5	2.0	4.0	5.0	5.6	6.5
1995	2.6	2.1	4.0	5.0	5.5	6.5
2000 & later	2.6	2.1	4.0	5.0	5.5	6.5

*Source: 1983 Annual Report - Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, June 27, 1983.

The estimates for the year 2000 (Table 10) show some moderation in social security costs under the II-B scenario and slightly higher costs as a share of GNP, under the pessimistic scenario. In both scenarios, expenditures for medicare (Hospital Insurance and Supplementary Medical Insurance) rise significantly. Depending on the policy for defense and on the economic scenario, interest costs would continue to climb, as a share of GNP, even though nominal interest rates are only 6.1 to 6.6 percent. By the year 2000, the deficit could be a bit lower than projected for 1988, 4.2 percent of GNP under the most optimistic case, or could rise to 9.9 percent of GNP under the more pessimistic scenario.

Table 10

Year 2000 Projections of Federal Outlays as a Percent of GNP - Using Social Security II-B and III Scenarios

	1988	Year 2000 IIB	Year 2000 III
OASDI --Retirement and Disability Part of Social Security	4.6%	4.3%	4.8%
HI --Hospital Insurance Part of Social Security	0.9%	2.0	2.6
Supplemental Medical Insurance (SMI)	0.3	1.0	1.3
Civil Service/Military Retirement	1.1	1.1	1.1
Other Nonmeans Tested Benefits	1.4	0.9	1.0
Means Tested Benefits	1.9	1.9	1.9
Grants	1.2	1.2	1.2
Other Operations/Subsidies Civilian Agency Payroll	1.4	1.4	1.4
Defense*	6.7	6.7 to 9.0	6.7 to 9.2
Interest	3.9	3.6 to 4.5	4.3 to 5.4
Total	24.6%	24.2% to 27.3%	26.3% to 29.9%
Deficits as a % of GNP:	5.4%	4.2% to 7.3%	6.3% to 9.9%

*The range gives what happens if (a) defense grows in real terms as fast as GNP after 1988 (low end) and (b) defense grows in real terms by 5 percent each year (upper end.) This range for defense expenditures under each scenario causes a range for interest costs.

By the year 2025, the situation becomes untenable, as shown in Table 11, with deficits shooting up well into double digits. Entitlements, like social security and medicare, play an important part in the projected long range growth of the deficit. But the acceleration in the growth in interest costs is most important. It turns out that although nominal interest rates are assumed to be below GNP growth rates throughout the period, the massive buildup of debt, because the budget excluding interest runs large deficits, causes the debt-GNP ratio to rise and interest costs to increase along with that ratio. The possibility of just such a "blowup" of interest costs has been raised by some economists, such as James Tobin and Albert Ando, but this is the only example I have seen of calculations that try to show the order of magnitude of the numbers.

Table 11

Federal Spending in 2025, As a Share of GNP -- Using Social Security II-B and III Scenarios

	1988	Year 2025 II-B	Year 2025 III
OASDI -- Retirement and Disability Part of Social Security	4.6	5.6%	6.7%
HI -- Hospital Insurance Part of Social Security	0.9	3.2	4.1
SMI -- Supplementary Medical Insurance	0.3	1.6	2.1
Civil Service/Military Retirement	1.1	1.1	1.1
Other Nonmeans Tested Benefits	1.4	0.6	0.7
Means Tested Benefits	1.9	1.9	1.9
Grants	1.2	1.2	1.2
Other Operations/Subsidies Civilian Agency Pay	1.4	1.4	1.4
Defense*	6.7	6.7 to 9.0	6.7 to 9.2
Interest	3.9	6.3 to 11.6	11.9 to 18.4
Total	24.6	29.7% to 37.2%	37.8% to 46.8%
Deficits as a % of GNP:	5.4%	8.7% to 16.2%	16.8% to 25.8%

The purpose of these long range projections, especially the 2025 estimate, is not to make a prediction. Neither we nor anyone else can foretell what policies and external shocks will come to pass over the next 50 years. Rather, the calculations represent another way of showing, first, that the problem of large deficits is not a temporary one and second that there is a very good chance that it will get worse unless something is done.

Statement Before the Task Force on

Entitlements, Uncontrollables, and Indexing

of the House Budget Committee

by

John L. Palmer*

November 9, 1983

*Senior Fellow, The Urban Institute.

Mr. Chairman and task force members, I appreciate the opportunity to testify before you today on H.R. 3790, the proposal introduced by Representatives Jones and Campbell to reduce the indexing in the income tax and in non means-tested entitlement programs by 2 percentage points each year during the 1985-1990 period. Before I comment on the specifics of the bill, let me review the context in which it is being considered.

Under current tax and spending policies, we face the prospect of unprecedented large deficits for the foreseeable future--ones that will almost surely be in excess of $200 billion or 4 percent of GNP towards the end of the decade. Furthermore, stronger than expected economic growth will do little to reduce these longer term deficits. They will be increasingly structural in nature--relecting a fundamental and growing imbalance between current tax and spending policies that will persist even in a full employment economy. Therefore, these deficits can only be remedied through legislative action. While I do not share the view of many economists that these deficits pose a grave threat to the current recovery, I do believe they represent a serious problem for the long run health of the economy which requires major legislative measures that should not be delayed beyond 1984.

The danger is not so much that the recovery will soon falter, since the increasingly stimulative fiscal policy inherent in the growing structural deficits should more than offset any effects of the inevitable high interest rates. Rather, it is that the recovery will be extremely unbalanced, characterized by high levels of consumption and defense spending and low levels of business investment and exports. This mix will impede rather than enhance the longer run growth of the economy that presumably was the target of the Reagan Administration's supply-side tax cuts.

To avoid this outcome, the structural deficit should be gradually reduced over the remainder of this decade. An appropriate intermediate goal for the structural deficit would be about one percent of GNP, which is similar to the level experienced during the 1960's. To attain such a target over a five-year period would require tax increases and reductions in program spending that would exceed $125 billion annually by FY88. We need to act quickly because you cannot get from here to there without significant disruptions if sizeable adjustments are suddenly implemented.

Given the magnitude of the desired deficit reduction, it is clear that substantial action will be required on all three major fronts--tax increases, further restraint for domestic program spending and a scaling back of the planned defense build-up. Complete implementation of the FY84 Congressional budget resolution would still leave us with a structural deficit well in excess of two percent of GNP in FY88. Even the addition of the full measure of the President's proposed domestic spending cuts would not be sufficient to achieve the one percent target.

H.R. 3790 fulfills a pressing need since it incorporates broad measures affecting both the revenue and spending sides of the equation. Proposals such as H.R. 3790 and ones recently put forward in the Senate, such as Senator Dole's deficit reduction package, that link tax increases and spending cuts offer hope for constructive solutions to the current budget dilemma. However, as I describe below, H.R. 3790 as presently formulated raises several serious issues.

The tax provisions of H.R. 3790 would reduce the indexing provisions for the personal income tax, due to take effect in 1985, by 2 percentage points below the called-for CPI adjustment. By FY90 this provision is estimated by the CBO to yield $31.3 billion annually, which would represent a little less than a 3 percent increase in the federal tax burden (federal taxes as a percent of GNP) and a 2 percent increase in the total tax burden above where current policies would place them.

I favor the principle of indexation of the personal income tax system. However, under the current circumstances it appears to be a luxury we cannot yet fully afford, given the current structure of the tax system. Some reduction in this indexing feature is a reasonable way to raise a portion of the much larger total tax increase that will be needed to address the deficit problem. It is relatively neutral in its distributional effects and spreads a small burden widely over the entire taxpaying population.

However, I would note two things. First, for reasons of both equity and efficiency, it would be preferable to rely entirely upon base broadening measures to raise any additional revenues. The efficiency and equity of many tax expenditures are highly questionable. Just as direct outlay programs have been subjected to close scrutiny in the search for spending restraint, so should current limitations to taxable income. These special subsidies are much less defensible in light of the compelling national interests at stake in the search for major deficit reduction measures. A reduction in tax indexation has the effect of raising marginal tax rates slightly. My judgment that a reduction in tax indexation is desirable is predicated on the assumption that it is simply not feasible to achieve all of the needed revenue increases over the next five years through base broadening measures. However, every effort should be made to emphasize such measures.

Second, while taxpayers with higher incomes have realized a sizeable reduction in their tax burdens over the past three years, lower income taxpayers have not. In fact, the lower income population has incurred an increase in its tax burden since 1980 as sales, excise and payroll taxes have risen, inflation has pushed their earnings up into a range where a much greater portion of it is liable for income taxes (since recent tax cuts did not affect the level of personal exemptions and the zero bracket amounts), and the real value of the Earned Income Tax Credit has been eroded. Whether indexation is reduced or not, some steps ought to be taken to offset the rising tax burdens for this population, who have also borne the brunt of the spending cuts. One that recommends itself is to increase and then index the Earned Income Tax Credit.

Now let me turn to the spending features of the bill. H.R. 3790 would also reduce the indexing of non means-tested entitlement programs by 2 percentage points below the normal CPI adjustment starting in 1985. The CBO estimates that this would save $25.3 billion in outlays annually by FY90. The vast majority of these savings would come in the social security program. Lesser amounts would be realized in military and civil service retirement programs.

If one accepts the notion that further domestic spending restraint is an essential ingredient of any major deficit reduction scheme, then some sort of an across-the-board COLA reduction such as this ought to be considered. Along with Medicare, these middle class entitlement programs account for about half of domestic spending and a far greater portion of its projected growth. There is simply no way to achieve substantial additional reductions in domestic spending without focusing on these non means-tested entitlements unless the remainder of the budget is to be decimated.

There are additional arguments in support of the COLA reduction. First, until recent technical changes were made, COLA's actually overadjusted for actual cost-of-living increases. Second, the beneficiaries of these programs have been largely protected from the budget cuts to date. For example, the only provision affecting the average social security recipient before the next century is the recent six month delay in the COLA adjustment which amounted to a 2 percent reduction in real benefits. In the past, the inferior economic status of the aged has led society to be far more generous in public policies affecting them relative to the non-aged. However, recent studies have revealed that the aged have achieved an economic status on a par with the rest of the population. Thus, it is not unreasonable to ask them to share equally in the sacrifices necessary to reduce the deficit.

More importantly, if retirement programs are going to contribute significantly to deficit reduction efforts this decade, COLA reductions are a fair way to accomplish this. This is because they spread the pain in small doses over large numbers of people and yield immediate savings. Adjustments in the SSI program can ensure that low income recipients are not affected.

Having extolled the virtues of COLA reductions as a general means of achieving domestic spending restraint, I must now express grave concerns about the particular form in which they are embodied in H.R. 3790. In short, I believe the particular provisions of this bill reduce social security benefits excessively relative to the revenue increase. Furthermore, the provisions reducing COLA's raise a serious issue of equity among current and prospective social security recipients.

Let me elaborate on these points by discussing the consequences of this bill for some typical families. I pointed out earlier that the increase in revenues by FY90 would reflect a rise of a less than 2 percent in the total tax burden. This will translate into a reduction in disposable income of well under one percent for the average taxpayer. Although the total deficit reduction impact of the spending cut is slightly less than that of the tax cut, it has a far more detrimental impact on disposable income of those affected, since there are far fewer program recipients than taxpayers. For social security recipients already on the rolls in 1985, the cumulative effect of six two percentage point reductions in the CPI adjustment is a real benefit reduction of about 11 percent annually by 1990. Since social security comprises a large share of the aged's income, this benefit reduction will translate into a reduction in disposable income of anywhere from, say, 5 to 8 percent for most recipients, and up to 11 percent for the unfortunate minority highly dependent on social security for income.

For recipients who newly enter the rolls between 1985 and 1990, the consequences will be less severe, since they will be subject to fewer years' reductions in their COLA. This, however, will create serious inequities among retirees with similar wage histories. In the extreme, by 1990 a retiree who has been on the rolls since 1984 will be receiving an 11 percent lower benefit than a new retiree with an identical (properly indexed) wage history.

Despite the urgent need for action on the deficit and the general desirability of COLA reductions, I do not believe that a spending cut of this nature is defensible. First, the inequity among current and prospective recipients is too great and the impact on longer term recipients too severe. Longer term recipients, if any, are the group that we should ask to bear a less than average share of the burden, since they are likely to be more dependent upon social security income. Fortunately, there are various technical ways of addressing this problem which I urge you to consider.

Second, the reduction in disposable income for program recipients, particularly social security recipients, is much too high relative to that for taxpayers. I realize there is some superficial appeal in the symmetry of an equivalent reduction in indexing of both taxes and COLAs. But, as I hope I have made clear, the result for the affected individuals and families is far from equivalent. Even full postponement of the indexation of taxes would have less consequences for the disposable income of the typical taxpayer than would a 1 percent reduction in COLAs for the disposable income of the typical recipient.

In summary, I believe proposals to link reductions in tax and COLA indexation are a desirable ingredient of a much needed strategy to reduce projected structural deficits by 3-4 percent of GNP by the late 1980's. However, such proposals should be designed to yield both far greater aggregate savings in taxes relative to spending and a more equitable distribution of the benefit cuts among recipients than would H.R. 3790.

ERLENBORN QUESTIONS AND ANSWERS

Q: Re COLA, FAIR would allow COLA to $10K floor with 60% over that?

A: Yes - $10K floor indexed to CPI, plus 60% over that.

Q: Any response from OMB & OPM on savings?

A: No, not until January or February 1984.

Q: Re thrift plan, like an IRA?

A: No, going in would be fully taxed--also, matching employer contribution up to 3%.

Advantage--capital formation resulting from thrift plan available for use.

Q: Cost of thrift plan?

A: Uncertainty re extent of government employee contribution but ultimately could easily reach 2% of payroll cost ($\pm$ 80% employee participation after 5 or so years).

Q: Why offer early retirement at all?

A: It is consistent with broad practices in the private sector, everything considered.